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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1936

No. 389

THE KNOX NATIONAL FARM LOAN ASSOCIATION, A CORPORATION, AND THE FEDERAL LAND BANK OF LOUISVILLE, A CORPORATION,

Petitioners,

vs.

ARTHUR C. PHILLIPS,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEALS OF KNOX COUNTY, OHIO.

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Petitioners,

vs.

ARTHUR C. PHILLIPS,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEALS OF KNOX COUNTY, OHIO.

To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioners respectfully pray for a writ of certiorari herein to review the final decision and judgment (R. pp. 107, 114) of the Court of Appeals of Knox County, Ohio, which is the highest court of said State having jurisdiction over this case, except upon the discretionary assumption of jurisdiction by the Supreme Court of Ohio, the court

of last resort of said State.* Said decision and judgment became final June 24, 1936, when the Supreme Court of Ohio overruled petitioners' motion for an order directing said Court of Appeals to certify its record to said Supreme Court (R. p. 115.)†

Neither the decision of the Court of Appeals (rendered April 16, 1936), nor the order of the Supreme Court of Ohio overruling said motion, has yet been reported in the official reports of either court.

The jurisdiction of this Court is invoked under § 237 of the Judicial Code, as amended (28 U. S. C. § 344 (b)).

Statement of Facts.

Petitioners, hereinafter referred to as the Association and the Bank, are corporations chartered by the Federal Farm Loan Board (now Farm Credit Administration) pursuant to the provisions of an Act of Congress approved July 17, 1916, known and cited as the Federal Farm Loan Act (12 U. S. C. §§ 641, *et seq.*; 39 Stat. 360).

The Association is a cooperative membership corporation. Its office is located in Knox County, Ohio. It is engaged in the business of procuring farm mortgage loans for its farmer members, upon its indorsement, from the Federal Land Bank of Louisville, Louisville, Kentucky.

The provisions of law which control the organization, operation and dissolution of the Association are contained in §4, §§ 7–11, § 25 and § 29 of said Act as amended (12

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* Constitution of Ohio, Art. IV, § 6. "* * * judgments of the courts of appeal shall be final in all cases except * * * cases of public or great general interest in which the supreme court may direct any court of appeals to certify its record to that court."

† *American Railway Express Co.* v. *Levee*, 263 U. S. 19, 20.

U. S. C. § 676, §§ 711–761, § 921 and §§ 961–966), and are reviewed at length in this court's opinion in *Federal Land Bank* v. *Gaines*, 290 U. S. 247.

Respondent became a member and shareholder of the Association in 1927. At that time he purchased a farm in Knox County, Ohio, and assumed a mortgage which had been given by his vendor to the Bank to secure a loan obtained through the Association. At the same time, respondent assumed the stock interests of his vendor (53 shares of paid-up stock in the Association, with a par value of $5 each), and became a member of the Association, as permitted by § 12, Sixth, of the Act (12 U. S. C. § 771, Sixth) (R. p. 47). Respondent's stock was held by the Association as collateral security for the payment of said loan, pursuant to the requirement of §§ 7 and 8 of the Act (12 U. S. C. §§ 721, 733). The Association's receipt for such stock stated, in part, that respondent's stock in the Association "will be accepted at face value upon final payment of the loan." No provision of this character was contained in the Act or in the note and mortgage held by the Bank (R. pp. 29, *et seq.*).

The mortgage loan was payable in installments over a period of 34½ years, but respondent had the option of paying off the unmatured balance or any part thereof on July 1, 1930, or on any installment date thereafter. On March 25, 1933, respondent made the following tender to the Bank, as in full payment of his debt: cash in the amount of $1,857.50; together with respondent's stock in the Association, the par value of which ($265), added to said cash, was equal to the unpaid balance of the mortgage debt as of the next installment date. This tender was refused (R. pp. 3, 4).

Thereafter, respondent paid the sum of $1,857.50 on account of his mortgage debt, and brought suit against the

Association and the Bank in the Court of Common Pleas of Knox County, Ohio, praying for a judgment substantially as follows: (1) that the Bank be required to accept his association stock at par in full payment of its loan, and cancel its mortgage; (2) that his title to the real estate be quieted as against said mortgage; and (3) that a receiver be appointed to wind up and liquidate the affairs of the Association, which was alleged to be continuing its business notwithstanding an impairment of its capital stock. Answers were filed by both defendants, and a cross petition was filed by the Bank, praying judgment for the balance of the mortgage debt not theretofore paid in cash.

It was established that for more than two years before the trial, the Association's current assets (excluding capital) had been less than its obligations to the Bank for defaults under mortgages indorsed for its members (R. p. 57). A statement of the Association's financial condition, introduced in evidence by the respondent, showed a deficit equal to 4.04 per cent of its capital stock at the date of the trial, the Bank being the only creditor (R. p. 72, Exhibit "B").

The Association and the Bank had agreed upon a method for liquidating the Association's obligations. This agreement was made in 1931, while respondent was a member of the Association. It authorized the Bank to retain and apply to the Association's account any sums which otherwise would be payable, including dividends on bank stock owned by the Association, and the proceeds thereof on retirement (R. p. 87, Exhibit "F").* The agreement was

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* The Act requires that the Association purchase stock in the Bank in the amount of 5% of each loan obtained for a member, and pledge such stock as collateral security for the indorsed loan. The bank stock shall be paid off at par and retired upon full payment of the indorsed loan. Federal Farm Loan Act, § 7; 12 U. S. C. § 721.)

executed on a standard form approved in 1929 by the Federal Farm Loan Board (now Farm Credit Administration).

During the two year period preceding the trial, the Association had indorsed and become liable to the Bank for new loans in excess of $100,000 (R. p. 57).

The case was tried in April of 1935, but no decision was rendered until October 7 and November 18 of 1935, when the trial court entered two separate judgments (R. pp. 93, 97) disposing of different phases of the case. By the first judgment, filed October 7, the court adjudicated the amount which was owing by Phillips to the Bank, and ordered that the Bank cancel and deliver up its mortgage upon payment of said sum in cash. Both Phillips and the Bank complied with the provisions of said judgment, as appears from the preliminary recitals of a subsequent order of the court (R. p. 97), *and all controversy respecting title to the real estate was thereby concluded.*

On November 18, 1936, the court decided the remaining issues in the case, awarding judgment against the Association for the par value of Phillip's stock ($265) and appointed a receiver to liquidate and wind up the Association (R. p. 97).

Upon petition in error to the Court of Appeals of Knox County, Ohio, the judgment and decision of the Court of Common Pleas was affirmed (R. p. 107).

Specification of Errors to be Urged.

The court erred—

1. In affirming judgment against the Association for the par value of respondent's stock.

2. In holding that the Federal Farm Loan Act requires the Federal Land Bank to credit the maker of a mortgage note with the proceeds of collateral security (bank stock) owned and pledged by the indorser of the note (the na-

tional farm loan association of which the maker is a member and shareholder).

3. In affirming the appointment of a receiver to wind up and liquidate the Association's business.

4. In holding that the Ohio statutes, relative to the appointment of a receiver in an action to quiet title to real estate, were applicable to this case; and in failing to recognize that all controversy relative to title had been eliminated upon respondent's payment of the entire mortgage debt, during the interim between the filing of suit and the appointment of a receiver to liquidate the Association and that the sole remaining questions involved the interpretation of the Federal Farm Loan Act.

Reasons for Granting the Writ.

1. The court below has decided Federal questions of substance which have not been settled by this Court.

2. The rights and obligations of the parties to this case are controlled by the Federal Farm Loan Act, a statute of the United States, which has been erroneously interpreted and applied by the court below.

3. The decision below is in conflict with the rule applied by United States District Courts and Circuit Courts of Appeal, in passing upon the claims of shareholders against insolvent membership corporations such as building and loan associations. The Federal rule should have been followed in interpreting the provisions of the Federal Farm Loan Act with respect to the retirement of stock by an insolvent national farm loan association.

4. The entire Federal land bank system is concerned with the basic issues involved in this case, which may be summarized as follows:

(a) Does the relationship of debtor and creditor arise between a national farm loan association and a shareholder who seeks to withdraw his capital and retire from membership at a time when the association is insolvent?

(b) May judgment be rendered against an insolvent national farm loan association in favor of one member, for the par value of his stock, thereby according him a preference over the creditors and remaining members of the insolvent association?

(c) Does the Federal Farm Loan Act confer upon the Farm Credit Administration exclusive jurisdiction to regulate and wind up the affairs of an insolvent national farm loan association?

(d) May a national farm loan association be liquidated by a judicial receivership, merely upon the ground of insolvency, at the suit of a single shareholder? If such jurisdiction exists, does it extend to an association whose insolvency is limited to a slight impairment of capital, and whose gross assets are far in excess of the amount requisite to pay obligations to creditors?

Answers to the foregoing questions are of immediate practical importance to the land bank system. The Federal land banks hold 634,000 mortgage loans* indorsed by national farm loan associations, with unpaid balances of $2,005,000,000. In connection with each loan, the indorsing association has subscribed to capital stock in the bank (5% of the amount of the loan), and has pledged such stock as collateral security. Each borrower, in turn, has subscribed to a like amount of stock of his association, and has pledged such stock with the association as collateral security. The decision of this case involves the rights of the parties to a Federal land bank loan (borrower, association and bank) in the proceeds of these collateral pledges.

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* All statistics as of December 31, 1935.

A total of 5,034 associations are now in existence. About one third of these associations (1,649) are indorsing new loans, though presently unable to meet their obligations as indorsers of mortgages now in default, or to pay off the stock of retiring members at par. The last mentioned group of associations is operating under the same regulatory provisions which control the operations of the petitioner Association.* The total capital of this group of associations is approximately $47,995,640, all of which was subscribed under the same provisions of law as the stock involved in this case.

Conclusion.

Wherefore petitioners pray that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the Court of Appeals of Knox County, Ohio, commanding that court to certify and forward to this Court a full and complete transcript of the record of the proceeding in said Court of Appeals had in the case numbered and entitled on its docket 380, February Term, 1936, *Arthur C. Phillips* vs. *The Knox National Farm Loan Association and the Federal Land Bank of Louisville, Defendants-Appel-*

* Petitioners will request this Court to take judicial notice of the regulatory procedure of the Government and its application to the Association, and will supplement their brief by official publications on the subject, if a writ of certiorari is issued herein. Such publications will show that, pursuant to an administrative policy which has been followed for over seven years, associations are classified on the basis of financial condition; and that associations having a slight capital impairment are permitted to continue business operations, where there is a reasonable expectation of financial rehabilitation through operating revenues, sale of acquired real estate, etc.; and that the conditions imposed upon such continuance in business constitute proper safeguards to the association's creditors and shareholders.

lants, to the end that this cause may be reviewed and determined by this Court, as provided for by the statutes of the United States, and the petitioners may have such other and further relief in the premises as the Court may deem proper.

Respectfully submitted:

THE KNOX NATIONAL FARM LOAN
ASSOCIATION AND
THE FEDERAL LAND BANK OF LOUISVILLE,
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BRIEF IN SUPPORT OF PETITION.

Reference is made to the petition for statements relative to the following matters, which will not be repeated in this brief: opinion below, jurisdiction of this Court, statement of facts, assignment of errors, and questions presented.

Statute Involved.

The questions presented by this case are controlled by the Federal Farm Loan Act (39 Stat. 360) as amended. Said Act and amendments thereto are contained in Title 12, U. S. Code, ch. 7, §§ 641 *et seq.* The provisions of law which are particularly involved in the consideration of this case are set forth in the Appendix (*Infra* pp. 14-16).

Argument.

Both petitioners are instrumentalities of the Government of the United States, performing important public duties, and operating under the supervision and regulation of the Farm Credit Administration. *Smith* v. *Kansas City Title and Trust Co.*, 255 U. S. 180; *Federal Land Bank* v. *Gaines*, 290 U. S. 247; *Federal Land Bank* v. *Priddy*, 295 U. S. 229.

The association is a cooperative membership corporation which indorses and becomes liable for loans made to its members by the Federal land bank. The Act requires each member to subscribe to the association's capital, and provides that his subscription shall be paid off and retired upon full payment of his loan.

The Federal Farm Loan Act imposes the same implied restrictions upon the right to withdraw capital which have long been recognized in connection with building and loan associations. The Federal courts refuse to permit the

withdrawal of capital from a cooperative membership association unless such association is solvent. Under the rule applied by the Federal courts, it is neither requisite nor permissible for an insolvent cooperative association to retire its stock at par. *Coltrane* v. *Blake* (C. C. A. 4th), 113 F. 785, 787, 788, 792; *Kline* v. *Ariz. Mut. Sav. & L. Assn.* (C. C. A. 9th), 235 F. 694; *Aldrich* v. *Gray* (C. C. A. 6th), 147 F. 453; *Standard Sav. & L. Assn.* v. *Aldrich* (C. C. A. 6th), 163 F. 216; *Fidelity Sav. & L. Assn.* v. *Burnet* (App. D. C.), 65 F. (2d) 477, 479, 481.

The Act contemplates strict mutuality between the members of a national farm loan association, and no member may obtain a preference over his fellow members by withdrawing capital at time when the association is insolvent. *Byrne* v. *Federal Land Bank*, 61 N. D. 265, 237 N. W. 797; *Federal Land Bank* v. *Warner*, 42 Ariz. 201, 23 Pac. (2d) 563; *Western Clay National Farm Loan Association* v. *Lilly*, 189 Ark. 1004, 76 S. W. (2d) 55, See also *Toule* v. *Am. Build. L. & Inv. Soc.* (C. C.), 61 F. 446; *Sullivan* v. *Stucky* (C. C.), 86 F. 491, 493; *Lewis* v. *Clark* (C. C. A. 9th), 129 F. 570, 573; also cases cited in preceding paragraph.

A farm loan association has no power to confer upon its member the status of a creditor for the amount of his capital subscription, and any contract to that effect is unenforceable. *Kline* v. *Ariz. Mut. Sav. & L. Assn.*, (supra); *Standard Sav. & L. Assn.* v. *Aldrich* (supra); and line of cases decided by this Court on ultra vires contracts, including *McCormick* v. *Market Bank*, 165 U. S. 538, 549 and *Central Transp. Co.* v. *Pullman's Palace Car Co.*, 139 U. S. 24, 59.

The gross assets of the petitioning association greatly exceed its obligations to creditors. However, the association is insolvent, within the meaning of that term as applied to cooperative membership associations, for the reason that it cannot meet its obligations to creditors without impairment of capital. (See building and loan association cases,

supra.) Where a state of insolvency exists, the association's assets are impressed with a trust for the benefit of creditors and, under a long line of decisions by this Court, none of said assets may be distributed to shareholders.

Receivership is neither necessary nor proper, at the suit of a single shareholder, where the affairs of the cooperative association are being handled without waste or mismanagement, and particularly where there is a reasonable likelihood that the association may work out of its difficulties. *Battle, Com'r* v. *Repub. Sav. & L. Assn.*, 63 N. J. Eq. 578, 53 Atl. 11; *Sjoberg* v. *Sec. Sav. & L. Assn.*, 73 Minn. 203, 75 N. W. 1116; *Havemeyer* v. *Sup. Ct.*, 84 Cal. 327, 18 Am. St. Rep. 192; *People* v. *Union Build. & L. Assn.*, 127 Cal. 400, 58 Pac. 822, 59 Pac. 692; *Barton* v. *Enterprise L. & Build. Assn.*, 114 Ind. 226, 16 N. E. 486; 23 R. C. L. 25.

The Federal Farm Loan Act confers exclusive jurisdiction upon the Farm Credit Administration to wind up insolvent national farm loan associations. This Court has stated that under § 29 of the Act (12 U. S. C. §§ 961-964) "receivership is available only through the favorable action of the Farm Credit Administration." *Federal Land Bank* v. *Priddy*, 295 U. S. 229.

A state cannot, by legislative or judicial action, assume jurisdiction over an association which is financially embarrassed. The assertion of such jurisdiction interferes with the exercise of discretion by the Farm Credit Administration, which may give such association an opportunity to escape final insolvency, and to work out of its difficulties without receivership. *Easton* v. *Iowa*, 188 U. S. 220.

Conclusion.

The decision below is erroneous with respect to Federal questions of great importance to instrumentalities of the United States. A conflict exists between the decision below

and the rule of the Federal courts as to the rights of the retiring shareholder of an insolvent cooperative membership corporation. The petition for certiorari should, therefore, be granted.

Respectfully submitted:

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APPENDIX.

Federal Farm Loan Act,* Approved July 17, 1916, 39 Stat. 360, 365.

§ 4. (12 U. S. C. § 676.) Among the powers expressly conferred upon each national farm loan association by this section is the power "to have succession until it is dissolved by Act of Congress or under the provisions of this chapter." (This section, which relates particularly to Federal land banks, is applicable to national farm loan associations. § 7, Federal Farm Loan Act; 12 U. S. C. § 716.)

§ 7. (12 U. S. C. § 721.) "Whenever any national farm loan association shall desire to secure for any member a loan on first mortgage from the Federal land bank of its district it shall subscribe for capital stock of said land bank to the amount of 5 per centum of such loan, such subscription to be paid in cash upon the granting of the loan by said land bank. Such capital stock shall be held by said land bank as collateral security for the payment of said loan, but said association shall be paid any dividends accruing and payable on said capital stock while it is outstanding. Such stock may, in the discretion of the directors, and with the approval of the Farm Credit Administration, to be paid off at par and retired, and *it shall be so paid off and retired upon full payment of the mortgage loan. In such case the national farm loan association shall pay off at par and retire the corresponding shares of its stock which were issued when said land bank stock was issued.*" (Italics added.)

§ 8. (12 U. S. C. § 733.) "* * * Any person desiring to borrow on farm land mortgage through a national farm loan association shall make application for membership and shall subscribe for shares of stock in such farm loan as-

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* All quotations are from *U. S. Code*, which substitutes "Farm Credit Administration" and "administration" for "Federal Farm Loan Board" and "board", pursuant to Executive Order 6084.

sociation to an amount equal to 5 per centum of * * * the desired loan, said subscription to be paid in cash upon the granting of the loan. If the application for membership is accepted and the loan is granted, the applicant shall, upon full payment thereof, become the owner of one share of capital stock in said loan association for each $100 of * * * his loan * * *. *Said capital stock shall be paid off at par and retired upon full payment of said loan.* Said capital stock shall be held by said association as collateral security for the payment of said loan, but said borrower shall be paid any dividends accruing and payable on said capital stock while it is outstanding." (Italics added.)

§ 9. (12 U. S. C. § 744.) "Shareholders of every national farm loan loan association shall be held individually responsible, equally and ratably, and not one for another, for all contracts, debts, and engagements of such association to the extent of the amount of stock owned by them at the par value thereof * * *."

§ 29. (12 U. S. C. § 961.) "Upon receiving satisfactory evidence that any national farm loan association has failed to meet its outstanding obligations of any description the Farm Credit Administration may forthwith declare such association insolvent and appoint a receiver and require of him such bond and security as it deems proper: *Provided*, That no national farm loan association shall be declared insolvent by said administration until the total amount of defaults of current interest and amortization installments on loans indorsed by national farm loan associations shall amount to at least $150,000 in the Federal land bank district, unless such association shall have been in default for a period of two years. Such receiver, under the direction of the Farm Credit Administration, shall take possession of the books, records, and assets of every description of such association, collect all debts, dues, and claims belonging to it, and, with the approval of the Farm Credit Administration, or upon the order of a court of record of competent jurisdiction, may sell or compound all bad or doubtful debts, and, on a like approval or order, may sell all the real and personal property of such association, on such

terms as the Farm Credit Administration or said court shall direct."

§ 29. **(12 U. S. C. § 962.)** "Such receiver shall pay over all money so collected to the Treasurer of the United States subject to the order of the Farm Credit Administration, and also make report to said administration of all his acts and proceedings. The Secretary of the Treasury shall have authority to deposit at interest any money so received."

§ 29. **(12 U. S. C. § 964.)** "If any national farm loan association shall be declared insolvent and a receiver shall be appointed therefor by the Farm Credit Administration, the stock held by it in the Federal land bank of its district shall be canceled without impairment of its liability and all payments on such stock, with accrued dividends, if any, since the date of the last dividend shall be first applied to all debts of the insolvent farm loan association to the Federal land bank and the balance, if any, shall be paid to the receiver of said farm loan association: *Provided*, That in estimating said debts contingent liabilities incurred by national farm loan associations under the provisions of this chapter on account of default of principal or interest of indorsed mortgages shall be estimated and included as a debt, and said contingent liabilities shall be determined by agreement between the receiver and the Federal land bank of the district, subject to the approval of the Farm Credit Administration, and if said receiver and said land bank cannot agree, then by the decision of the Land Bank Commissioner, and the amount thus ascertained shall be deducted in accordance with the provisions of this section from the amount otherwise due said national farm loan association for said canceled stock."